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Trumponomics: Deja vu Reaganomics?

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The Trump era is going to be very different, at least judging by the pile of hyperboles building up from experts' commentary on the subject: "game changer," "paradigm shift," "regime change," "upending the global order," "one of those major reversals that last a decade"—to name a few of the descriptors.

The basic components of Trump's domestic economic agenda seem to include: corporate and personal tax cuts, spending on infrastructure and defense, and deregulation—especially in the energy sector. Comparisons between his agenda and the Reagan era of the early 1980s have been quick to follow. Ronald Reagan took a supply-side swipe at the economy, slashed taxes, spent money on defense, and worked to deregulate the economy. Together with Paul Volcker –the tough-love Chairman of the Federal Reserve (Fed)—the Reagan/Volcker policy mix of easy fiscal/restrictive monetary policy is credited with guiding America to a path of strong growth and falling inflation, lower bond yields, and a multiple-expansion/profit-driven secular bull market in stocks. The early read on Trump's domestic economic agenda, therefore, seems to contain enough of a whiff of Reaganomics to imply that a significant realignment in the U.S. monetary-fiscal policy mix lies ahead from what has prevailed over the last eight years.

The exact details of Trump's program are important. How will the tax cuts and spending increases be financed? Will the administration use a combination of domestic tax carrots and foreign tax sticks to manipulate the location of business investment? What components in his plan will revitalize manufacturing and boost middle income prosperity? How protectionist will trade policy turn out to be?

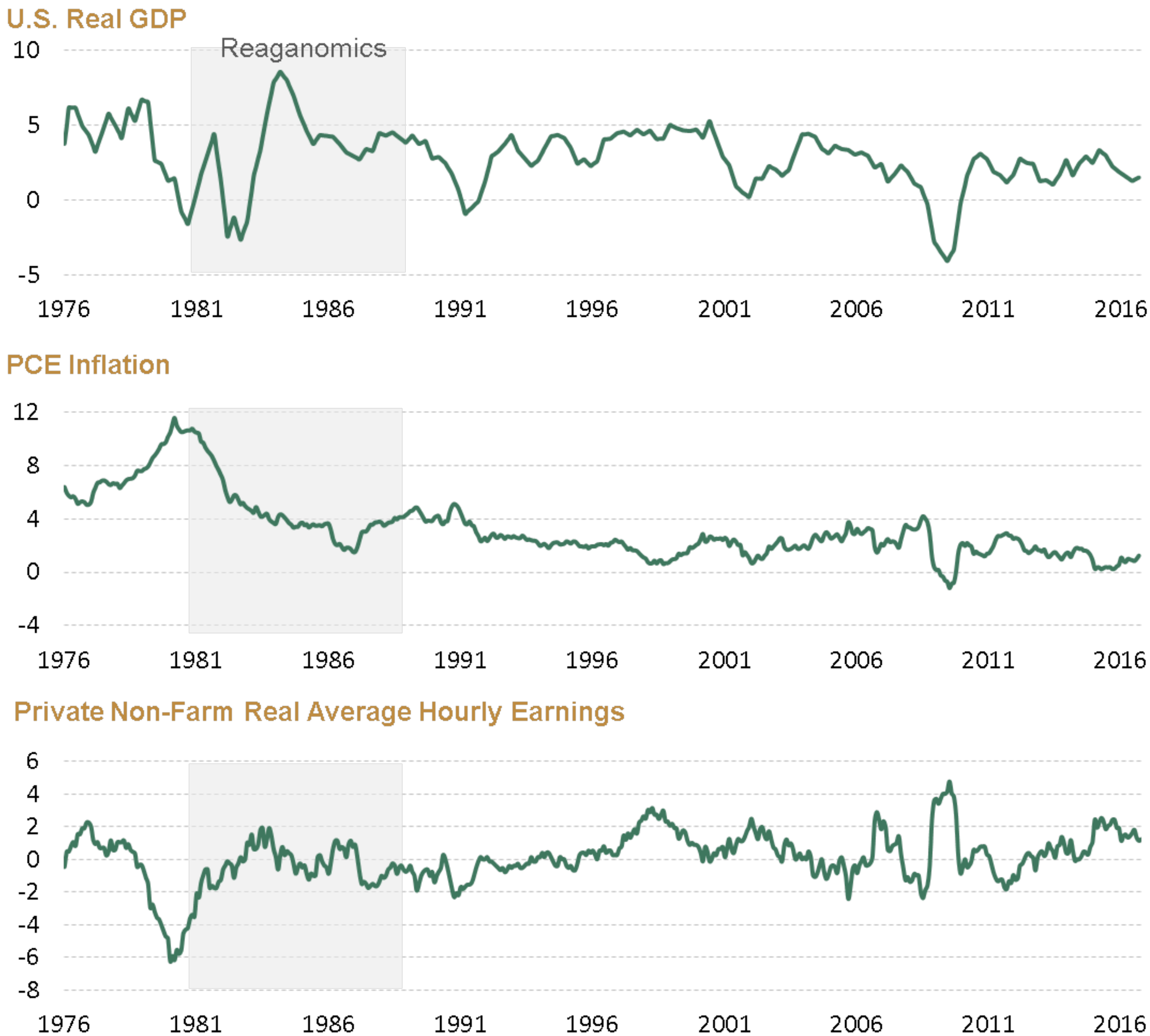
But markets are not waiting for specifics. Investors expect the domestic agenda to be good for the economy. Correspondingly, bond yields have moved sharply higher since the election. Stock prices are up modestly, although the real story has been the violent pro-cyclical sector rotation. The dollar is up as well, but not as aggressively as might be expected based on the 40% appreciation in the real broad dollar index that took place after Reagan took office in 1981.

There is not enough information to draw even tentative conclusions about the implications of the yet-to-be disclosed Trump agenda. What can be said, however, is that the current economic backdrop to any kind of Reagan-like regime shift is very different from the economic conditions that prevailed 30 years ago at the start of the Reagan era. The differences in the two economic profiles could be as significant a determinant to the Trump era as the forthcoming details of Trump's policies themselves.

There are at least three major differences between the economic situation today and what prevailed over 30 years ago.

1. Reagan came to power in 1981 and implemented aggressive fiscal stimulus in the middle of what turned out to be the longest recession in the post-war period. The tax cuts came at a time of depressed cyclical and secular demand and helped ignite a slingshot recovery in real gross domestic product (GDP) growth to over 9% by 1983 (see Chart 1). Price inflation was almost 11% in the early 1980s but collapsed to below 4% by 1985. Real wage growth was deeply negative in the early 1980s and rose to about 2% in early 1984 before falling back below zero in 1985-86.

Chart 1 *Annual Percent Change, As of 10/31/2016*



Note: Gray area indicates period of Reaganomics from 1981-1988.
Source: Thomson Datastream

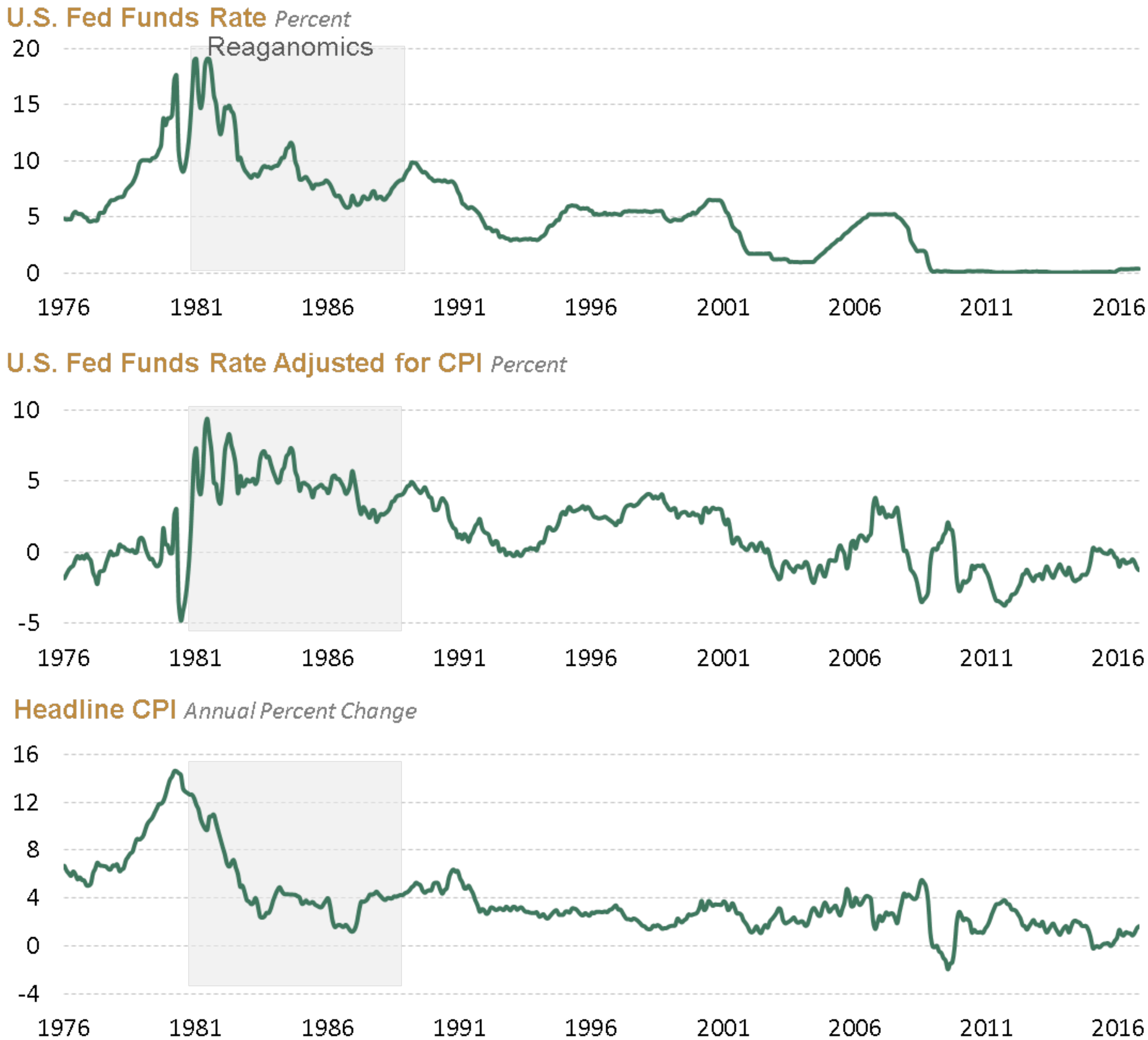
In contrast with this earlier period, the U.S. economy currently is in the eighth year of one of the longest expansions on record. The unemployment rate is close to levels most believe equate to near full employment. Real wage growth has been rising steadily since 2011 and is already close to 2% or higher depending on how it is measured. Core consumer price index (CPI) inflation is above 2% where it has hovered since about 2012.

The significance of the difference in economic profiles between the two time periods is that stimulative fiscal policy could be more stagflationary than expansionary, at least initially. In other words, more of the stimulus would play out in higher price and wage inflation than economic growth, which would be bad for bonds and possibly stocks. A pick-up in productivity could defray some of this stagflationary reaction, but the timing of major fiscal stimulus at this point in the economic cycle seems more likely to boost prices than output—at least in the short term. Measures to deregulate could be more effective for productivity but in the longer term. None of this is overly positive for the dollar, but its outlook could be heavily influenced as well by the reaction of the Fed.

2. **The Volcker Fed wanted to crush inflation in the early 1980s. The federal funds rate fluctuated greatly in**

those years. It peaked at over 19% in 1981, fell to 8.5% by 1983, rebounded to almost 12% in 1984 before sinking below 6% in 1986, see Chart 2. However, the real or inflation-adjusted federal funds rate averaged above 6% from 1982 to late 1984, with nominal interest rates significantly higher than nominal GDP. Headline CPI inflation fell from roughly 15% in 1980 to almost 1% by 1986.

Chart 2 *As of 10/31/2016*



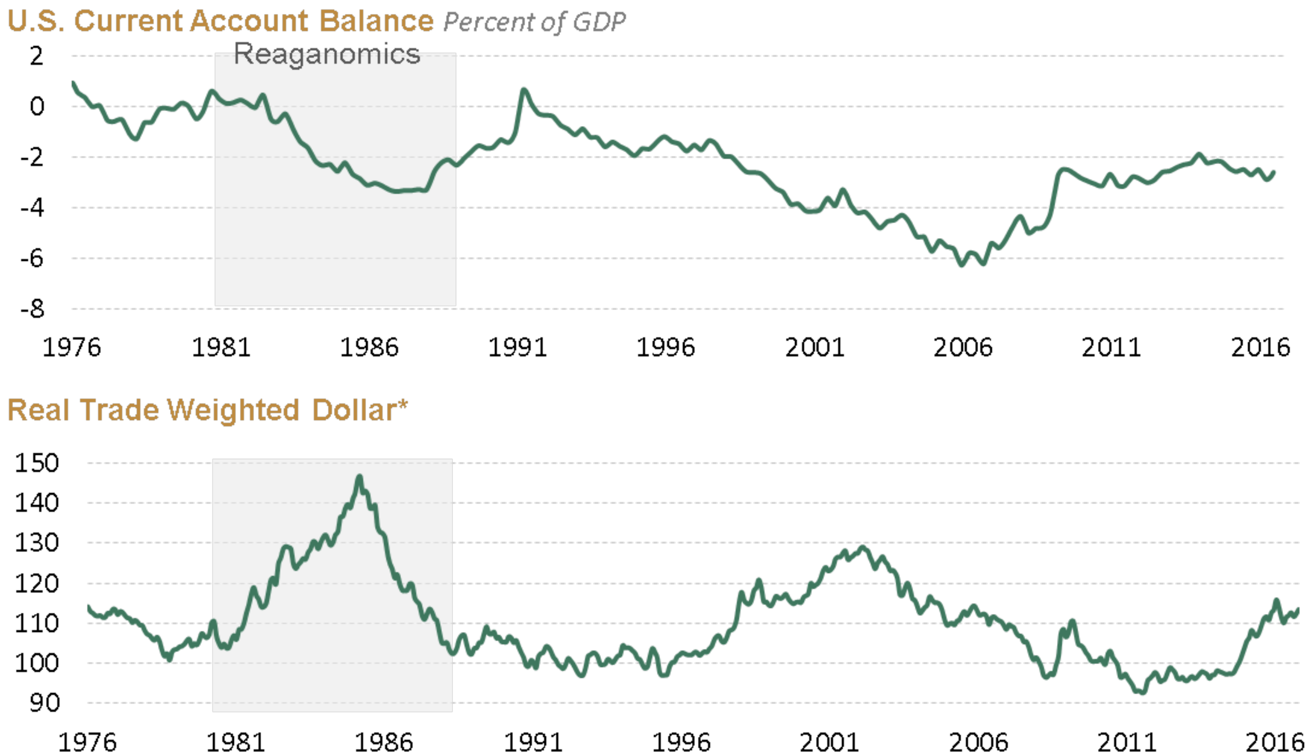
Note: Gray area indicates period of Reaganomics from 1981-1988.
Source: Thomson Datastream

In contrast, the Yellen Fed has been debating the merits of letting the economy run hot enough for inflation to build up some momentum. The issue for monetary strategy has been what kind of policy to run in order to escape the zero-bound world of the last eight years. With inflation slowly picking up, real short-term interest rates are negative and nominal GDP growth has been running ahead of interest rates since 2010. In addition, the recent flattening in the money multiplier (M2/monetary base) suggests that any dollar scarcity created by the post-crisis increase in the demand for liquidity or money may be finally coming to an end.

The significance of these differences in monetary policy between the two time periods plays to the outlook for inflation and the U.S. dollar. The kind of tight-fisted monetary stance of the early 1980s does not exist currently and as such poses a challenge to the case for another super bull market in the U.S. dollar. The real broad trade-weighted U.S. dollar rose 40% from the beginning of 1981 to its peak in 1985. This run-up was the biggest part of the 7-year bull market, which really started in 1978 and took the index up 50%. It is true that the dollar has already advanced 22% over a 5-year period with rates at zero. But this period has said more about weakness outside of the U.S. than American strength. Since then, conditions around the world have stabilized and are more in balance.

3. During the early 1980s, the U.S. current account as a share of GDP was slightly positive (see Chart 3). Under Reaganomics, the federal budget deficit never really recovered from the recession levels of -4.5% of GDP until after 1987, while the personal savings rate fell from over 12% in 1981 to 7.5% in 1986. This trend toward domestic dissaving—together with the strong dollar—manifested in a current account deficit which exceeded 3% of GDP by 1986. The drag from the drop in real net exports reduced GDP growth from its peak in 1983 to 2% by 1986.

Chart 3 *As of 10/31/2016*



Note: Gray area indicates period of Reaganomics from 1981-1988.
**Source: JP Morgan*
Source: Thomson Datastream

American manufacturing was so hollowed out by the drop in competitiveness that the U.S. orchestrated the Plaza Accord in 1985 to encourage multilateral coordination aimed at lowering the dollar. The number of manufacturing jobs in the U.S. peaked at 19.5 million in late 1979. It fell to a low of 16.7 million in 1983 before starting to recover. But the dollar rally and the trade imbalance capped the recovery in jobs at 18 million by 1984. Jobs in manufacturing hovered near that level for 15 years before collapsing after 2000, when China officially joined the World Trade Organization in 2001.

In contrast with Reagan in 1981, Trump will take office with the current account deficit already close to 3% of GDP. Any increase in the government budget deficit on the back of tax cuts and spending increases, along with private sector dissaving, will only make the external deficit bigger. Dollar strength would be especially penalizing—owing to the much more competitive nature of the global economy today. The emerging and developing world currently comprises over 60% of global GDP. In addition, the protectionist rhetoric of the campaign seems to fly in the face of the need to fund an even larger external deficit, not to mention public debt. Net public debt-to-GDP was less than 30% in the early 1980s; currently it is closer to 90%.[1]

What Trump really needs is a major depreciation in the real value of the U.S. dollar to bring manufacturing jobs back to America—not an increase. Dollar strength hollowed out American manufacturing in the 80s and supply siders blamed that development on the Fed. The dollar surge reflected back on a 54% decline in the price of gold, the supply-side standard for monetary stability. There was considerable speculation earlier this year that the G20 secretly agreed to work toward stabilizing the dollar during the February meetings in Shanghai, and the Fed has become more sensitive to dollar strength since that time. Going forward, agreements of this sort could make sense both for the U.S. and the rest of the world. In addition, Janet Yellen's term is up in early 2018. It seems almost inevitable that some kind of regime change will follow at the Fed.

A few summary thoughts

In the aftermath of the U.S. election, investors have bet that expansionary fiscal policy and tighter monetary policy is forthcoming. The reaction to that expectation has lifted bond yields and the dollar which, in and of themselves, represent a tightening in liquidity conditions. These trends could peter out and/or may partially reverse as early as the next quarter if the anticipated change in the fiscal/monetary mix is delayed, not forthcoming, or falls short of expectations.

More generally, the contrasts between the current economic profile and what existed in the early 1980s, when the fiscal/monetary policy mix changed under the Reagan administration, argue for a market response that differs from what took place 30 years ago—and generally a more muted one. A more stagflationary response to fiscal stimulus is negative for duration. The stock market, already well advanced, seems more vulnerable to multiple compression on the back of any retreat from duration.

Lower taxes are always good for a currency, but dollar strength makes the economy less competitive and would thwart one of Trump's most important goals, which is to bring manufacturing jobs back to America and boost middle class real income. In addition, it would make the external funding requirement larger. How these possible developments get addressed will be important in driving market returns during the Trump era. The great irony could be that after naming China a currency manipulator, the two great powers get together in an attempt to manipulate the dollar in a way to stave off the kind of appreciation experienced during the Reagan administration, which at the time prompted the Plaza Accord, to drive it back down. Regime change at the Fed is another likely prospect in 2018.

The biggest potential risk for the economy and capital markets in Trump's agenda is his trade policy. Protectionism is unambiguously negative for the economy and asset markets. At the moment, most investors seem hopeful that his protectionist rants were only campaign rhetoric. Instead the expectation is growing that his administration more likely will pivot the focus of U.S. trade policy from multilateral free trade to bilateral fair trade. If so, that would be another page from the Reagan playbook. Reagan's record on trade fell so far short of his free trade image that the late, great Milton Friedman was prompted to write an op-ed in *The Wall Street Journal* in 1987 complaining that the Reagan administration's trade initiatives made the Smoot-Hawley Tariff look benign. It was not until the 1990s that free trade legislation began to gather momentum.

[1]Source: Organization for Economic Cooperation and Development

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